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SENSITIVE

STATE FOR E, EUR/SE, AND EUR/IFD
TREASURY FOR OASIA - MMILLS, RADKINS
NSC FOR BRYZA AND MCKIBBEN

E.O. 12958: N/A
TAGS: EFIN EIND ECON TU
SUBJECT: UPDATE ON THE (STALLED) PRIVATIZATION PROGRAM

1.(Sbu) Summary. The travails of the Tupras privatization and recent meetings with Privatization Authority (PA) officials and other contacts confirm that Turkey,s privatization program continues to be plagued by PA mistakes, which opens the way for vested interests to use the courts to block privatizations and an excessive focus on the proceeds of the sale rather than the efficiency gains to the economy. The bottom line is that only one significant privatization has taken place since the current government came to power, and all the major privatizations seem to be moving at a snail's pace. On June 10, Finance Minister Unakitan optimistically claimed the GOT would realize deals worth $2.3 billion in 2004, of which $468 million would be in cash. End Summary.

Overview

¶2. (Sbu) Although the current Government is widely considered to support privatization more than previous governments, its track record continues to underwhelm. In 2003 (AKP,s first full year in power), the GOT projected privatization proceeds for the year of USD four billion, and for the period 2003-06 of 12.4 billion. 2003 was marked, however, by high-profile debacles--the failures of Tekel tobacco and Petkim--and slow motion on the other large privatizations. Finalized deals totaled only some USD 900 million, most of which were small transactions. For 2004, GOT reduced its target for total sales to only USD 1.2 billion. Trying to put the best possible face on the situation, at a press conference June 10, just after the courts blocked the $1.3 billion Tupras privatization, Finance Minister Unakitan claimed the GOT would realize sales in 2004 worth $2.3 billion of which only $468 million would be in cash. These estimates seem highly optimistic, even if the Tupras deal goes through. Just in the past year, the GOT 's inability to conclude three large privatizations has cost it $3 billion in revenues and, more importantly, an opportunity to accelerate the reform process and enhance market confidence.

¶3. (Sbu) In separate meetings with econoffs, Privatization Authority President Metin Kilci and Vice President Osman Ilter claimed they were proceeding as quickly as possible, but the subtext of the discussions was that any particular privatization will occur only if the sale price is politically palatable.

4.(Sbu) Post has previously reported the PA,s problems with excessively high internal valuations, and officials, fears of being criticized or even prosecuted for selling below the internal valuation. Moreover, senior GOT officials tend to focus only on the fiscal benefit to the state from the proceeds of the privatization, rather than on the efficiency gains to the economy. PA President Kilci told us that senior GOT officials measure the PA's success purely in terms of revenue raised.

5.(Sbu) In recent weeks, as the Tupras privatization has become ensnarled in the courts (see below), two post contacts from outside the government have privately accused the PA of technical and legal incompetence that leaves it open to court challenges from the many vested interests opposed to privatization. Faik Oztrak, the former Treasury Undersecretary, told econcouns that the PA is required to accept only unconditional bids, but accepted a conditional bid on the Tupras deal. Likewise, Ergun Okur, EVP of Oyak Group, said the PA had made mistakes in conducting the Tupras privatization process.

6.(Sbu) If the privatization process seems slow now, it may get worse: Kilci acknowledged that the PA has about a year to finalize its most contentious divestitures, before political considerations render tough choices impossible. As set forth below, the PA faces a huge challenge in meeting this deadline.

Tupras (Refinery)

¶7. (Sbu) Tupras has been in the PA portfolio since 1990. A tender last fall produced a high bid of USD 1.3 billion to a consortium of the Russian oil company Tatneft and the Turkish conglomerate, Zorlu group. The sale was originally expected

to be concluded by the end of 2003, but the sale has been delayed by difficult contract negotiations and by lawsuits brought by Tatneft,s minority shareholders and by Tupras unions. Shortly after Kilci opined to us that the sale would be finalized by the end of June, an appeals court reinstated a lower court restraining order blocking the sale. While the PA may well be successful in its appeal to the Council of State, this sell-off is already being compared to the 2003 Petkim and Tekel debacles. As Tupras is the only possible near-term &win8 for the PA, if the appeal is lost the PA,s credibility, such as it is, will be badly damaged.

Petkim (Petrochemicals)

¶8. (Sbu) Petkim also has been in the PA portfolio since 1990. Though the PA had accepted the bid by the Uzan group,s Standart Kimya in 2003, once the Uzan group companies were seized over the Imar Bank collapse, Standart Kimya was unable to come up with the funds to make the initial payment, and the PA had to cancel the tender. It then re-tendered the company, only to cancel the tender in January for lack of interest. Kilci said he hopes to announce a tender this year or early next year, but first he &wants to see some good financial statements.8 (For 2004 Q1, Petkim reported a USD 40 million loss.) At his press conference, Unakitan said the PA would re-tender by the end of the year. Comment: The problem with waiting for &good financial statements8 is two-fold: First, the wait could be long. Second, in its valuations PA seems to apply to earnings a much higher multiple than do investors. As such, as a company,s performance improves, it perversely becomes more difficult to sell, because the discrepancy between the PA,s valuation and those of potential purchasers is magnified. End Comment.

Erdemir (Iron and Steel)

¶9. (Sbu)   Erdemir has been in the PA portfolio since 1987. Ilter explained that the PA wants to delay the block sale of the state,s 50% interest in Erdemir until (a) its publicly-traded stock recovers the value it recently lost (because of what Ilter considers an overreaction by the market to a fall in Chinese steel purchases), (b) the Tupras sale is concluded (thus demonstrating the &credibility8 of Turkey,s privatization program), and (c) additional investors show interest (two have shown interest so far, but Ilter very much wants to see other investor interest). Comment: The PA will be waiting a very long time for all three of Ilter,s conditions to come into alignment. Ilter,s caution is unfortunate: Erdemir has been profitable in 2003 and likely in 2004, benefiting from surging local demand from the booming Turkish auto and white goods sectors, and probably could be sold relatively quickly. Econoff recently visited Erdemir,s headquarters in the Black Sea town of Eregli and will report septel. End Comment.

Turkish Airlines (THY)

¶10. (Sbu) THY has been in the PA portfolio since 1990. Ilter explained that the PA is considering a limited public offering of 20-30 percent with a subsequent block sale. Kilci thought the IPO could be concluded before the year end. Ilter revealed that the Transport Minister has held up approval to prepare for the IPO. According to Ilter, this is probably because of the Transport Minister,s irritation that the PA, under the authority of Finance Minister Unakitan, has the lead on the THY privatization.

Tekel (Tobacco)

¶11.   (Sbu) Tekel has been in the PA portfolio since 2001. The GOT,s rejection last fall of the high ($1.3 billion) bid for Tekel,s tobacco operations has left the PA frantically -- and to date unsuccessfully -- searching for options. Kilci said that the PA is trying to develop a &more attractive model.8 However, the only meaningful alternative that has been suggested) separate sales of individual brands -- is not under consideration. The privatization of Tekel,s smaller alcohol operations was successfully completed earlier in 2004, the only significant company privatized by the GOT in the past year.

Turk Telekom

12.(Sbu) Turk Telekom (TT) has been slated for sale since 1998, though consideration of TT,s privatization began in the 1980s. TT is perhaps the most politically controversial of the potential privatizations, and the TT privatization process comes under its own special legislative framework. Although technically not part of the PA,s portfolio, the PA is involved in the TT sell-off. The GOT seems to be proceeding diligently to address the many problems that must be resolved before this sale can proceed, such as amending the public procurement law to allow the PA to retain a financial advisor for the sale. Kilci agreed that labor is

TT,s biggest problem, and said that a bill has been submitted to Parliament that will aid TT,s downsizing. Kilci also stated, however, that the PA can best handle the labor problem by finding a &good customer8 for TT.

¶13. (Sbu) The U.S. Trade and Development agency has financed a U.S. consultant doing a study of TT,s information technology upgrade needs. Econoffs recently met with the consultant, who described a company with serious systems problems. The consultant said TT desperately needed investment in new systems, and he wondered about the company,s ability to manage IT projects. The consultant said TT had clearly underinvested for years, lacked a customer service mindset, and badly needs strengthened management, marketing and systems.

Electricity Distribution

14.(Sbu) Under the GOT,s recently-agreed energy sector strategy, elaborated with the help of the World Bank, the GOT plans to privatize some government-owned generation facilities and divide the country's distribution network into 21 regions, creating a joint stock company for each region, and establishing regional tariffs. The difficulty is that, in the Eastern part of Turkey, up to 80 percent of all electricity is stolen. The total loss nationwide is estimated at $1.75 billion annually. Thus, at present, with a national tariff system, the Western part of Turkey, in which leakage is much smaller, is subsidizing the Eastern part of Turkey. Kilci advised that the World Bank has now agreed with GOT to maintain national tariffs for five years, during which time the GOT expects private distribution companies to significantly reduce losses.

State Bank Privatization:

¶15. (Sbu) The privatizations of state-owned Ziraat and Halk Banks, and of state-controlled Vakif Bank are central elements in IMF and World Bank programs in Turkey. In the course of the negotiations over the IMF,s Seventh Review, in March and April, the GOT agreed with the IFI,s on a state bank privatization strategy for Halk and Ziraat, and continues to try to resolve ownership structure issues that prevent the privatization of Vakif. As reported earlier, the strategy is to shrink Ziraat and Halk*especially their outsized government securities portfolios*to prepare for eventual privatization. Though Halk and Ziraat management initially behaved contrary to the strategy, by aggressively competing for consumer lending business, several contacts have confirmed that these banks have finally been reined in by Treasury, and are no longer undercutting private banks, lending rates. Rodrigo Chavez, the World Bank economist who has the lead on the state bank issue, told econoff the plan is for the GOT to pull $5 billion in capital out of Ziraat and Halk in the coming months. He said the GOT moved rather quickly to select an advisor, McKinsey, who is already working on the process. Comment: Despite the progress, and Chavez, optimism, the privatization of these banks, with their gigantic branch networks and payrolls, is likely to be a very long process. End Comment.

Comment:

¶16. (Sbu) Though the privatization program is seriously undermined by widespread anti-privatization attitudes, litigious labor unions, and unsympathetic and capricious courts, the GOT itself has yet to demonstrate that it understands the efficiency gains that could be obtained from faster privatization, or has the will and competence to speed up the process. The GOT has proven adept at convincing the IFI,s that it is working towards privatization, while, by and large, only the small companies are actually transferred to the private sector.

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